THE WHITE HOUSE

WASHINGTON

MEMORANDUM FOR THE PRESIDENT

FROM: Ed Meese, Chairman Pro-Tempore
Cabinet Council on Management and Administration

SUBJECT: Financing of Federal Assistance

Attached is a paper prepared by OMB requesting approval to proceed with a new method for financing Federal assistance programs to States. The proposed changes have been discussed with State representatives (budget officers, auditors, controllers, treasurers). They agree with the general direction of the proposal.

FINANCING OF FEDERAL ASSISTANCE PROGRAMS TO THE STATES

The following report describes the Administration's initiative to improve cash management practices with the States and requests approval to proceed.

BACKGROUND:

The Federal Government disburses approximately $84 billion to the States each year for Federal assistance programs. The General Accounting Office, the Inspectors General, the Joint Financial Management Improvement Program, and the President's Private Sector Survey on Cost Control have criticized the Federal Government's methods for disbursing these funds. They claim that such methods result in the accumulation of large balances of excess Federal cash in the States, and that this costs the Federal Government millions of dollars annually in unnecessary interest costs. OMB estimates that the excess balances total over $900 million.

In order to reduce this excess Federal cash held outside the Treasury, the Department of Health and Human Services (HHS) initiated a "delay-of-draw method" for financing the Medicaid and the Aid to Families with Dependent Children (AFDC) programs. With this method, a State issues warrants or checks for program purposes. Since, however, it can take seven or more days before the warrants or checks are presented for payment, the State does not obtain Federal funds to cover the warrants or checks until just before they are estimated, according to historical patterns, to be presented for payment. HHS estimates that excess Federal cash for the Medicaid and AFDC programs was reduced by $411 million in the 30 States in which it was able to initiate the delay-of-draw method.

The method, however, is not without disadvantages. As many as 26 States claim bitterly of constitutional or statutory restrictions that require cash to be physically on hand in State bank accounts prior to the issuance of warrants or checks, and that the delay-of-draw method forces them to use their own funds or to borrow to cover the issuance of warrants or checks. From the Federal Government's perspective, the method does not completely eliminate excess cash. Residual balances representing a one- to two-day supply of cash remain in the States' bank accounts.

The method is also time-consuming and administratively burdensome to operate, particularly for the States who have to develop and monitor a separate check clearance pattern for each Federal program. Finally, the method is untested outside of the AFDC and Medicaid programs. In fact, it is probably not feasible for programs that have small numbers of large disbursements and/or for which the check clearance patterns are sporadic, e.g., highway construction, sewer construction.

As a result of objections raised by the States to the delay-of-draw method, nine Senators (Baker, Dole, Thurmond, Durenberger, Lugar, Quayle, Boren, Hawkins, and Cranston) entered into a colloquy on the Senate floor in December 1982, expressing concern with this method and noting the need for a uniform, equitable, and Government-wide cash management system for funding <u>all</u> grant programs to the States. The Senators agreed not to pursue legislation if the Administration would work jointly with the States to obtain a uniform and equitable system for financing grant programs.

Accordingly, OMB, Treasury, and HHS officials entered into negotiations with representatives of the National Association of State Budget Officers (NASBO) and the National Association of State Auditors, Comptrollers, and Treasurers (NASACT) to develop mutually agreeable policies for financing Federal grant programs to States. These negotiations could have major implications for the Federal Government and this Administration. They will decide how over $84 billion in Federal assistance funds will be disbursed to States each year. If the negotiations are successful, the Federal Government could recover as much as $900 million in excess cash held by the States, and save close to $200 million each year in interest costs.

At the same time, the negotiations have New Federalism implications. Federal officials are taking a flexible posture by giving the States a number of financing options to choose from. If the negotiations are successful, it will prove that New Federalism and cash management improvement are not conflicting objectives of this Administration.

PRESENT STATUS:

OMB, Treasury, and HHS have already met twice with representatives of NASBO and NASACT to develop equitable policies for financing Federal assistance programs. A copy of these policies, which have been reviewed and accepted by OMB, HHS, Treasury, Education, and Transportation, is attached. The key point of the policies is that we are offering the States three options for receiving Federal assistance funds. These are:

- Checks-paid method. Under this method, the State issues warrants/checks against an operating account and the warrants/checks are processed according to normal bank procedures. At a predetermined time each day, the State's commercial bank totals the warrants/checks presented against the account that day, initiates a drawdown of Federal funds, and receives almost instantaneously funds from the Federal Government. While this method is similar to the "zero balance" concept used in the private sector by most large corporations, it would be constitutionally or statutorily prohibited or otherwise unacceptable in most States.

- Delay-of-draw method. Under this method, the State issues warrants or checks for program purposes against its operating account. The warrants or checks are processed according to normal bank procedures. Using historical warrant/check clearance patterns, the State requests its commercial bank, as often as daily, to draw down funds from the Federal Government to cover the warrants or checks it expects will be presented for payment the next business day.

- Checks-issued method (with funds maintained in a separate bank account and interest credited to the U.S. Treasury on the account balances). Under this method, the State prepares warrants or checks for program purposes but holds issuance of the warrants or checks until the Federal Government transfers funds to cover the warrants/checks. The funds are placed in a separate bank account and the warrants/checks are processed through normal banking procedures. Interest is credited to the U.S. Treasury monthly on the average daily balance in the account at the Federal funds rate.

The checks-issued/interest-earned method is the most advantageous for all parties and will probably be accepted by the majority of the States. The reasons are as follows.

- It provides a viable alternative for States that have constitutional or statutory limitations or administrative difficulties implementing the checks-paid or delay-of-draw method.

- It can be used for all programs, even those with small numbers of large disbursements and/or sporadic check clearance patterns. Thus, one system can be used for all programs.

- A separate bank account greatly improves the ability of Federal agencies to monitor and audit cash held by States.

- The Federal Government earns interest on 100 percent of the Federal funds in State accounts.

- It is the simplest and least burdensome for Federal and State Governments.

Our next meeting with representatives of NASBO and NASACT is scheduled for June 22, 1983. It is expected that at this meeting they will accept the proposed policies for financing Federal assistance programs. Officials from OMB, Treasury, and HHS can then begin to develop with the State representatives a memorandum of understanding to guide implementation of the proposed policies. Since the checks-issued/interest-credited option is new, Treasury will test this method in three or four States in order to resolve any procedural or operational matters that may arise.

REQUEST TO PROCEED:

____ As stated, this initiative has the potential of saving close to $200 million a year in interest costs. It also has very positive Federalism implications. We thereby request approval to proceed with the policies and approach as described.

______ YES ______ NO

____ Approval to provide background and information materials to White House Communications and Speechwriters, after acceptance of policies by NASBO and NASACT, so that the President can get recognition.

______ YES ______ NO

Attachment

POSSIBLE CASH MANAGEMENT POLICIES

1. Intergovernmental cash management practices are such that neither the Federal nor State Governments benefit financially or are penalized financially as a result of the transfer of cash in support of Federal assistance programs.

2. A State is considered to benefit when it possesses cash provided by the Federal Government prior to the time the cash is needed to redeem a presented warrant or honor a presented check. The Federal Government is considered to benefit when its share of a disbursement is redeemed by a State using its own funds. The Federal Government is considered to be penalized when it provides cash that is not needed by a State at that time to cover the Federal share of a disbursement. A State is considered to be penalized when it pays from its own funds the Federal Government's share of a disbursement.

3. The Federal Government shall make grant allocations and awards expeditiously, and shall process bills and release and transfer cash in an expeditious manner so that funds are available to meet States' cash needs.

4. States shall bill based on actual cash needs or a close approximation of expected cash needs (plus the allowances for depreciation, amortization, and other similar costs, if allowed), and shall bill as close as possible to the time of actual or expected cash needs.

5. The preferred technique for making disbursements to States for all Federal assistance programs is one that provides results closest to the policies set forth in this paper--that is, funds are available at exactly the time they are needed to redeem a presented warrant or honor a presented check.

   However, due to the variety of constitutional, statutory, and administrative restrictions existing among the 50 States, several techniques for transferring cash between Federal agencies and State governments shall be made available for selection by each State. These techniques are:

   -- Checks paid letter of credit.

   -- Estimated checks cleared letter of credit.

   -- Checks issued letter of credit (with Federal funds maintained in a separate bank account and interest paid on the average daily balance).

6. States selecting the checks issued letter of credit option shall:

   -- Draw down Federal funds as close as possible to the time of release of warrants or checks by the State;

   -- Maintain all Federal funds in a separate bank account, with accountability by program; and

   -- Pay or credit the U.S. Treasury interest on the average daily balance of Federal cash on hand computed at the Federal funds rate.

7. Since the checks issued letter of credit option is new, there should first be a pilot test in three or four States in order to resolve any initial procedural or operational matters that may arise.

8. Each State will use the same cash management technique for all Federal programs in which it is participating.

9. Federal agencies and each State government will move as quickly as possible to adopt the technique chosen by the States.

10. All transfers of funds between the States and the Federal Government shall be accomplished by wire transfer to ensure quick delivery of funds.

11. Except where constrained by statute, the Federal Government will move to revise those regulations requiring that States disburse their own cash prior to seeking reimbursement from the Federal Government.

12. States will apply sound businesslike practices when disbursing Federal funds to secondary recipients and contractors, and not disburse or handle such cash at a faster rate or in a different manner than it handles its own cash.

13. Disbursements to retainage accounts (i.e., the amount retained under progress payments for construction and other contracts) maintained under the control of a State are not considered disbursements for the purposes of determining benefits and penalties.

14. For Supplemental Security Income State supplement payments, the same cash management procedures shall be followed except the State will be considered the disbursing agent and the Federal Government the payee.

15. The Federal Government is willing to work with States and State organizations to consider other financing systems or methods proposed by the States as long-range or future alternatives.

16. Each State will assign the name and title of a specific State official(s) with the statutory and administrative authority to bind all State agencies and to review, approve, and/or enter into an agreement with the U.S. Government for the purpose of implementing these cash management policies.